

## **Staff Report to the Illinois Commerce Commission**

### **Audit and Investigation of Commonwealth Edison Company**

**November 30, 2001**

#### **Capsule Summary**

In late 1999, Commonwealth Edison Company ("ComEd" or "Company") embarked on a massive program of capital and operating initiatives to remedy serious problems in its transmission and distribution systems for delivering electricity to retail customers. The program continued through calendar 2000. On June 1, 2001, ComEd filed a petition ("Rate Petition") requesting, among other things, that the Illinois Commerce Commission ("Commission") (1) order residential delivery services into effect by the statutory deadline in the spring of 2002, and (2) determine that ComEd's jurisdictional delivery services revenue requirement is \$1,787.0 million, a number which would include delivery service rates for residential customers and which would substantially increase its already existing delivery services rates for nonresidential customers. The Rate Petition was assigned Docket No. 01-0423. The delivery services revenue requirement sought in the Rate Petition is based upon a calendar 2000 test year.

For the reasons set forth below, Staff recommends that the Commission initiate a management audit and investigation of ComEd under Section 8-102 of the Public Utilities Act to examine the reasonableness, prudence, and efficiency of ComEd's operations, costs, management, decisions, and functions for the period leading up to, and during, calendar 2000, insofar as they affect the reasonableness or prudence of the costs underlying the rates or charges for utility service ComEd seeks in Docket No. 01-0423.

#### **Section 8-102 of the Public Utilities Act**

The Commission has invoked its authority under Section 8-102 on a number of occasions in the past, generally in order to satisfy itself that the utility was managing its operations to provide adequate, safe, efficient, and reliable service at reasonable rates. See, for example, Commission Orders in Docket Nos. 87-0232 and 88-0302. The issues presented by ComEd's Rate Petition have warranted a review of the breadth of that Section. Section 8-102 reads in full as follows:

Sec. 8-102. Audit or investigation. The Commission is authorized to conduct or order a management audit or investigation of any public utility or part thereof. The audit or investigation may examine the reasonableness, prudence or efficiency of any aspect of the utility's operations, costs, management, decisions or functions that may affect the adequacy, safety, efficiency or reliability of utility service or the reasonableness or prudence of the costs underlying rates or charges for

utility service. The Commission may conduct or order a management audit or investigation only when it has reasonable grounds to believe that the audit or investigation is necessary to assure that the utility is providing adequate, efficient, reliable, safe, and least-cost service and charging only just and reasonable rates therefor, or that the audit or investigation is likely to be cost-beneficial in enhancing the quality of service or the reasonableness of rates therefor. The Commission shall, before initiating any such audit or investigation, issue an order describing the grounds for the audit or investigation and the appropriate scope and nature of the audit or investigation. The scope and nature of any such audit or investigation shall be reasonably related to the grounds relied upon by the Commission in its order.

Any audit or investigation authorized pursuant to this Section may be conducted by the Commission, or if the Commission is unable to adequately perform the audit or investigation, the Commission may arrange for it to be conducted by persons independent of the utility and selected by the Commission. The cost of an independent audit shall be borne initially by the utility, but shall be recovered as an expense through normal ratemaking procedures. Any audit or investigation shall be conducted in accordance with generally accepted auditing standards.

## **Grounds for Audit Under Section 8-102**

### *Petition for Investigation and Audit*

Section 8-102 does not require the Commission to conclude that a utility has been mismanaged, or that rates are not just and reasonable, as a prerequisite to the conduct of an audit or investigation under that Section. Rather, the Commission may order an audit or investigation when it has reasonable grounds to believe that any of the statutory preconditions for an audit or investigation exist. Staff has reviewed the Petition for Investigation and Audit ("Petition") filed with the Commission on October 24, 2001, by the City of Chicago, the People of the State of Illinois by and through the Attorney General, the Cook County State's Attorney's Office, and the Citizens Utility Board, including the five exhibits thereto (ICC Docket No. 01-0664). Staff's position is that the sworn allegations contained in the Petition constitute reasonable grounds to believe that an audit or investigation is necessary to assure that ComEd's revenue requirement in Docket No. 01-0423 will result in just and reasonable rates for the provision of adequate, efficient, reliable, safe, and least-cost service.

### *Staff Testimony in ICC Docket No. 01-0423*

The direct and rebuttal testimony of Staff Witness Bruce A. Larson in Docket No. 01-0423 (Attachments 1 and 2 to this Staff Report) recount statements made by ComEd officers during the period from 1999 to 2001. Mr. Larson's testimony highlights the

extraordinary expenditures of resources needed to bring about the marked improvements that ComEd executives and others deemed necessary to bring the system into a more reasonable operating condition. Staff offers the statements cited and quoted in Mr. Larson's direct and rebuttal testimony, as well as Mr. Larson's own statements about the condition of the system and the resource expenditures ComEd made from 1999 to 2001 as further grounds to believe that an audit or investigation under PUA Section 8-102 is necessary to assure that ComEd is permitted to charge only just and reasonable rates for the provision of adequate, efficient, reliable, safe, and least-cost service.

#### *Additional grounds for investigation or audit*

In addition to the sworn allegations and the other facts presented in the Petition and in Mr. Larson's testimony in Docket No. 01-0423, Staff has reviewed the reports prepared for the Commission by the Liberty Consulting Group in the wake of the Summer 1999 electric service outages in ComEd's service area ("Liberty Reports"), and the Report submitted to the City of Chicago and the Commission by ComEd on September 15, 1999, in order to assist the Commission in determining whether reasonable grounds exist for the initiation of an audit or investigation. The highlights of that review are excerpted as Attachments 3 and 4 to this Staff Report, respectively, and further support the belief that an audit or investigation under PUA Section 8-102 is necessary to assure that ComEd is permitted to charge only just and reasonable rates for the provision of adequate, efficient, reliable, safe, and least-cost service.

#### **Recommended Scope of Audit under Section 8-102**

Section 8-102 requires that the Commission issue an order describing the grounds for an audit or investigation and the appropriate scope and nature of the audit or investigation, and further provides that the scope and nature of any such audit or investigation shall be reasonably related to the grounds relied upon by the Commission in its order. Staff has reviewed the grounds for the audit, as set forth in the Petition and the attachments to this Staff Report. Taken in their totality, these statements provide strong evidence that the ComEd transmission and distribution systems were, by late summer 1999, in a condition inimical to the provision of adequate, efficient, reliable, safe, and least-cost service.

Staff recommends that the Commission take action to determine the extent to which the expenditures which ComEd is seeking to include in rate base or in revenue requirements in Docket No. 01-0423 were necessitated by unreasonableness or imprudence of utility action or inaction in the period leading up to the filing of ComEd's Rate Petition. Recognizing that such an audit or investigation should not be open-ended in terms of the period scrutinized, Staff recommends special consideration of the following statements from the First and Third Liberty Reports:

“It is likely that a root cause of many of the service interruptions experienced by ComEd’s customers in recent years relates to less than adequate funding of T&D activities during the 1990s.” (First Liberty Report, page III-18)

“During the period 1992 through 1998, ComEd’s T&D capital and O&M expenditures declined. Moreover, especially with regard to capital, T&D received a diminishing share of a corporate budget that sometimes grew substantially. It is clear that this situation was not accidental.” (First Liberty Report, page III-15)

“There were signs that ComEd’s cost control efforts were having an adverse effect on T&D’s ability to serve its customers.” (First Liberty Report, page III-16)

“ComEd’s budget cutbacks that began in 1993 did not permit an amount of construction that was consistent with the age, load, and growth of ComEd’s distribution system.” (Second Liberty Report, page XV-12)

“Liberty also determined that the amount of distribution system construction that ComEd performed after 1992 was not consistent with the age and growth of the distribution system.” (Second Liberty Report, page XV-2)

Taken together, these statements suggest the need for an audit and investigation going back at least as far as the beginning of 1993. Based on the foregoing, Staff recommends that the Commission define the scope of the audit or investigation to include the reasonableness or prudence of:

1. management decisions related to budgets for ComEd’s transmission and distribution systems for the period 1993 through 2000;
2. ComEd’s actual expenditures related to the transmission and distribution systems for the period 1993 through 2000; and
3. management decisions and actions or inaction of ComEd related to the operation and maintenance of its transmission and distribution systems for the period from 1993 through 2000.

Reasonable grounds exist for the conduct of a management audit or investigation that (1) examines all aspects of ComEd’s operation of its transmission and distribution systems from 1993 through and including 2000, (2) examines the expenditures related to the transmission and distribution systems which ComEd is seeking to include in rate base or in revenue requirements in Docket No. 01-0423, (3) determines whether any such expenditures were in fact necessitated by the unreasonableness or imprudence of ComEd action or inaction during the period from 1993 through 2000, inclusive, and (4) if it is determined that any such expenditures were in fact necessitated by the unreasonableness or imprudence of ComEd’s action or inaction, recommends adjustments to the revenue requirement or rate base, or both, sought by ComEd in Docket No. 01-0423, using the quantification methodology considered by the

Commission in Docket No. 94-0040, or another methodology in a manner that will assure that the rates charged by ComEd on the basis of a calendar 2000 test year will be just and reasonable.

## **Transmission and Distribution**

Transmission and distribution systems are generally designed to operate as an interconnected system, different components of which can serve a number of different functions. Depending on system conditions, and the locations at which electricity is “fed into” and “used from” the system (often referred to as “sources” and “sinks,” respectively), the transmission system of a given electric utility might provide either or both of two functions. It might accept significant amounts of electricity from a neighboring transmission provider at one point on its system, and transmit that electricity to an end user within its own service area, or to another neighboring transmission provider, in order to effectuate a sale of power and energy over some distance. On the other hand, the system also functions to accept electricity from generation sources within the electric utility’s control area, transmit it to distribution centers, from which the electricity will be delivered, typically at a lower voltage, to end user customers.

Staff recognizes that the Federal Energy Regulatory Commission (“FERC”) has jurisdiction under the Federal Power Act and the rules it has adopted under that law over electric utilities, and facilities that those utilities use, that provide transmission services in interstate commerce. Staff further recognizes that pursuant to FERC rules, electric utility facilities are determined, on the basis of the so-called “seven-factor test,” to fall either under the jurisdiction of the FERC or under the jurisdiction of the relevant state public utility commission. Staff wishes to make clear that some ComEd facilities that are described as “transmission” facilities on company records fall within the category “high voltage distribution,” and are therefore jurisdictional to the Illinois Commerce Commission.

Furthermore, because of the interconnected nature of the transmission and distribution systems and because of the overlapping management systems and operations of ComEd, Staff recommends that the audit or investigation consider all actions and inactions of ComEd relevant to the distribution system, even if such actions and inactions might also relate to the transmission system. The goal should be a review of all relevant facts to arrive at ratemaking recommendations, if any, that relate to matters within the ratemaking jurisdiction of the Illinois Commerce Commission.

## **Generally Accepted Auditing Standards**

Section 8-102 of the Public Utilities Act requires that any management audit or investigation ordered by the Commission be conducted in accordance with generally accepted auditing standards. Staff recommends that, for the purpose of this audit or investigation, the General Accounting Office’s “Government Auditing Standards,” to the

extent applicable to an audit or investigation of this nature, be considered to be “generally accepted.”

### **Use of Outside Experts**

Section 8-102 of the Public Utilities Act states in part as follows:

Any audit or investigation authorized pursuant to this Section may be conducted by the Commission, or if the Commission is unable to adequately perform the audit or investigation, the Commission may arrange for it to be conducted by persons independent of the utility and selected by the Commission. The cost of an independent audit shall be borne initially by the utility, but shall be recovered as an expense through normal ratemaking procedures.

An analysis of the scope recommended above will likely involve thousands of hours of professional work. It will certainly require audit and investigative functions to be performed by professional auditors familiar with utility operations, engineering and management investigations by professional engineers familiar with the operation of large electric utilities, and potentially economic and financial analyses to be undertaken by professional economists and finance experts. Staff simply does not have the resources to perform the detailed review and analysis required by this undertaking in a timely manner, and thus recommends that outside experts be retained under Section 8-102.

In addition, Staff recommends that the outside experts who perform the audit and investigation retain legal counsel as a part of the overall engagement of experts under Section 8-102. The ultimate goal of the recommended audit and investigation is the presentation of evidence in a rate proceeding, and the expert witnesses will likely testify on a number of complex issues in Docket 01-0423. Staff's position is that the retention of counsel as part of the audit and investigation is essential to fulfill the statutory goal of furnishing assurance that the utility is charging only just and reasonable rates.

Staff's experience, both with audits conducted under Section 9-213 of the Public Utilities Act, and more recently with respect to audits related to the savings realized by SBC/Ameritech Illinois as a result of the merger of those two companies, is that independent experts, in order to maintain complete independence and the appearance of independence as they discharge the audit function and present formal testimony to the Commission, must be represented by counsel whose only function is to ensure legal representation for the independent witnesses themselves.

Based upon the foregoing, Staff recommends that the Commission's Order provide for the conduct of all aspects of the audit and investigation by persons independent of the utility and selected by the Commission, including the representation of auditors and investigators by counsel for all aspects of their participation in Commission proceedings. The Order should require that the cost of the independent

audit and investigation, including legal fees of independent counsel, be borne initially by ComEd, but should acknowledge that such cost and fees may be recovered as an expense through normal ratemaking procedures.

## **Conclusion**

Based upon the foregoing, Staff's considered view is that reasonable grounds exist for an audit and investigation of ComEd of the scope set forth in detail above. Staff recommends that the Commission order such an audit and investigation, adopt the General Accounting Office's "Government Auditing Standards," to the extent applicable to an audit and investigation of this nature, and require ComEd to pay for the cost of the audit, including legal fees for representation of the audit team, subject to subsequent recovery through normal ratemaking procedures.

Respectfully submitted,

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Harold L. Stoller  
Director  
Energy Division